is $159, the sum of the $96 section 199 deduction of the EAG allocated to Z for the first half of 2010 and Z's $63 section 199 deduction for the second half of 2010.

(h) *Computation of section 199 deduction for members of an expanded affiliated group with different taxable years*—(1) *In general*. If members of an EAG have different taxable years, in determining the section 199 deduction of a member (the computing member), the computing member is required to take into account the taxable income or loss, determined without regard to the section 199 deduction, QPAI, and W-2 wages of each other group member that are both—

(i) Attributable to the period that each other member of the EAG and the computing member are members of the EAG; and

(ii) Taken into account in a taxable year that begins after the effective date of section 199 and such taxable year ends with or within the taxable year of the computing member with respect to which the section 199 deduction is computed.

(2) *Example*. The following example illustrates the application of this paragraph (h):

Example. (i) Corporations X, Y, and Z are members of the same EAG. Neither X, Y, nor Z is a member of a consolidated group. X and Y are calendar year taxpayers and Z is a June 30 fiscal year taxpayer. Z came into existence on July 1, 2007. Each corporation has taxable income that exceeds its QPAI and has sufficient W-2 wages to avoid the limitation under section 199(b). For the taxable year ending December 31, 2007, X's QPAI is $8,000 and Y's QPAI is ($6,000). For its taxable year ending June 30, 2008, Z's QPAI is $2,000.

(ii) In computing X's and Y's respective section 199 deductions for their taxable years ending December 31, 2007, X's and Y's taxable income, QPAI, and W-2 wages from their respective taxable years ending December 31, 2007, are aggregated. The EAG's QPAI for this purpose is $2,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000)). Because the taxable years of the computing members, X and Y, began in 2007, the transition percentage under section 199(a)(2) is 6%. Accordingly, the EAG's section 199 deduction is $120 ($2,000 × .06). The $120 deduction is allocated to each of X and Y in proportion to their respective QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199 deduction. Pursuant to paragraph (c)(1) of this section, in allocating the section 199 deduction between X and Y, because Y's QPAI is negative, Y's QPAI is treated as being $0. Accordingly, X's section 199 deduction for its taxable year ending December 31, 2007, is $120 ($120 × $8,000/($8,000 + $0)). Y's section 199 deduction for its taxable year ending December 31, 2007, is $0 ($120 × $0/($8,000 + $0)).

(iii) In computing Z's section 199 deduction for its taxable year ending June 30, 2008, X's and Y's items from their respective taxable years ending December 31, 2007, are taken into account. Therefore, X's and Y's taxable income or loss, determined without regard to the section 199 deduction, QPAI, and W-2 wages from their taxable years ending December 31, 2007, are aggregated with Z's taxable income or loss, QPAI, and W-2 wages from its taxable year ending June 30, 2008. The EAG's QPAI is $4,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000) + Z's QPAI of $2,000). Because the taxable year of the computing member, Z, began in 2007, the transition percentage under section 199(a)(2) is 6%. Accordingly, the EAG's section 199 deduction is $240 ($4,000 × .06). A portion of the $240 deduction is allocated to Z in proportion to its QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199 deduction. Pursuant to paragraph (c)(1) of this section, in allocating a portion of the $240 deduction to Z, because Y's QPAI is negative, Y's QPAI is treated as being $0. Z's section 199 deduction for its taxable year ending June 30, 2008, is $48 ($240 × $2,000/($8,000 + $0 + $2,000)).

[T.D. 9263, 71 FR 31283, June 1, 2006, as amended by T.D. 9293, 71 FR 61679, Oct. 19, 2006; 72 FR 6, Jan. 3, 2007; T.D. 9381, 73 FR 8813, Feb. 15, 2008; T.D. 9384, 73 FR 12271, Mar. 7, 2008]

§ 1.199–8 Other rules.

(a) *In general*. The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code). When calculating the deduction under § 1.199–1(a) (section 199 deduction), taxpayers are required to make numerous allocations under §§ 1.199–1 through 1.199–9. In making these allocations, taxpayers may use any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, unless the regulations under §§ 1.199–1 through 1.199–9 specify a method. A change in a taxpayer's method of allocating or apportioning gross receipts, cost of goods sold (CGS), expenses, losses, or deductions (deductions) does not constitute a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. For purposes of §§ 1.199–1 through 1.199–9, use of terms such as *payment, paid, incurred,* or *paid or incurred* is not intended to provide any specific rule based upon the use of one term versus another. In general, the use of the term *payment, paid, incurred,* or *paid or incurred* is intended to convey the appropriate standard under the taxpayer's method of accounting.

(b) *Individuals.* In the case of an individual, the section 199 deduction is equal to the applicable percentage of the lesser of the taxpayer's qualified production activities income (QPAI) (as defined in § 1.199–1(c)) for the taxable year, or adjusted gross income (AGI) for the taxable year determined after applying sections 86, 135, 137, 219, 221, 222, and 469, and without regard to section 199.

(c) *Trade or business requirement*—(1) *In general.* Sections 1.199–1 through 1.199–9 are applied by taking into account only items that are attributable to the actual conduct of a trade or business.

(2) *Individuals.* An individual engaged in the actual conduct of a trade or business must apply §§ 1.199–1 through 1.199–9 by taking into account in computing QPAI only items that are attributable to that trade or business (or trades or businesses) and any items allocated from a pass-thru entity engaged in a trade or business. Compensation received by an individual employee for services performed as an employee is not considered gross receipts for purposes of computing QPAI under §§ 1.199–1 through 1.199–9. Similarly, any costs or expenses paid or incurred by an individual employee with respect to those services performed as an employee are not considered CGS or deductions of that employee for purposes of computing QPAI under §§ 1.199–1 through 1.199–9.

(3) *Trusts and estates.* For purposes of this paragraph (c), a trust or estate is treated as an individual.

(d) *Coordination with alternative minimum tax.* For purposes of determining alternative minimum taxable income (AMTI) under section 55, a taxpayer that is not a corporation must deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of the taxpayer's QPAI for the taxable year, or the taxpayer's taxable income for the taxable year, determined without regard to the section 199 deduction (or in the case of an individual, AGI). For purposes of determining AMTI in the case of a corporation (including a corporation subject to tax under section 511(a)), a taxpayer must deduct an amount equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of the taxpayer's QPAI for the taxable year, or the taxpayer's AMTI for the taxable year, determined without regard to the section 199 deduction. For purposes of computing AMTI, QPAI is determined without regard to any adjustments under sections 56 through 59. In the case of an individual or a non-grantor trust or estate, AGI and taxable income are also determined without regard to any adjustments under sections 56 through 59. The amount of the deduction allowable under this paragraph (d) for any taxable year cannot exceed 50 percent of the W-2 wages of the employer for the taxable year (as determined under § 1.199–2). The section 199 deduction is not taken into account in determining the amount of the alternative tax net operating loss deduction (ATNOL) allowed under section 56(a)(4). For example, assume that for the calendar year 2007, a corporation has both AMTI (before the NOL deduction and before the section 199 deduction) and QPAI of $1,000,000, and has an ATNOL carryover to 2007 of $5,000,000. Assume that the taxpayer has W-2 wages in excess of the section 199(b) wage limitation. Under section 56(d), the ATNOL deduction for 2007 is $900,000 (90 percent of $1,000,000), reducing AMTI to $100,000. The taxpayer must then further reduce the AMTI by the section 199 deduction of $6,000 (six percent of the lesser of $1,000,000 or $100,000) to $94,000. The ATNOL carryover to 2008 is $4,100,000.

(e) *Nonrecognition transactions*—(1) *In general*—(i) *Sections 351, 721, and 731.* Except as provided for an EAG partnership (as defined in §§ 1.199–3(i)(8) and 1.199–9(j)) and an expanded affiliated group (EAG) (as defined in §1.199–7), if property is transferred by the taxpayer to an entity in a transaction to which section 351 or 721 applies, then whether the gross receipts derived by the entity are domestic production gross receipts (DPGR) (as defined in §1.199–3) shall be determined based solely on the activities performed by the entity without regard to the activities performed by the taxpayer prior to the contribution of the property to the entity. Except as provided for a qualifying in-kind partnership (as defined in §§1.199–3(i)(7) and 1.199–9(i)) and an EAG partnership, if property is transferred by a partnership to a partner in a transaction to which section 731 applies, then whether gross receipts derived by the partner are DPGR shall be determined based on the activities performed by the partner without regard to the activities performed by the partnership before the distribution of the property to the partner.

(ii) *Exceptions*—(A) *Section 708(b)(1)(B)*. If property is deemed to be contributed by a partnership (transferor partnership) to another partnership (transferee partnership) as a result of a termination under section 708(b)(1)(B), then the transferee partnership shall be treated as performing those activities performed by the transferor partnership with respect to the transferred property of the transferor partnership.

(B) *Transfers by reason of death*. If property is transferred upon or by reason of the death of an individual (decedent), then the decedent's successor(s) in interest shall be treated as having performed those activities performed by or deemed to have been performed (pursuant to §1.199–3(i)(7) or §1.199–9(i)) by the decedent with respect to the transferred property. For this purpose, a transfer shall include without limitation the passing of the property by bequest, contractual provision, beneficiary designation, or operation of law, and successor in interest shall include without limitation the decedent's heirs or legatees, the decedent's estate or trust, or the beneficiary or beneficiaries of the decedent's estate or trust.

(2) *Section 1031 exchanges*. If a taxpayer exchanges property for replacement property in a transaction to which section 1031 applies, then whether the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of the replacement property are DPGR shall be determined based solely on the activities performed by the taxpayer with respect to the replacement property.

(3) *Section 381 transactions*. If a corporation (the acquiring corporation) acquires the assets of another corporation (the target corporation) in a transaction to which section 381(a) applies, then the acquiring corporation shall be treated as performing those activities of the target corporation with respect to the acquired assets of the target corporation. Therefore, to the extent that the acquired assets of the target corporation would have given rise to DPGR if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the target corporation, such assets will give rise to DPGR if leased, rented, licensed, sold, exchanged, or otherwise disposed of by the acquiring corporation (assuming all the other requirements of §1.199–3 are met).

(f) *Taxpayers with a 52–53 week taxable year*. For purposes of applying §1.441–2(c)(1) in the case of a taxpayer using a 52–53 week taxable year, any reference in section 199(a)(2) (the phase-in rule), §§1.199–1 through 1.199–9 to a taxable year beginning after a particular calendar year means a taxable year beginning after December 31st of that year. Similarly, any reference to a taxable year beginning in a particular calendar year means a taxable year beginning after December 31st of the preceding calendar year. For example, a 52–53 week taxable year that begins on December 26, 2006, is deemed to begin on January 1, 2007, and the transition percentage for that taxable year is 6 percent.

(g) *Section 481(a) adjustments*. For purposes of determining QPAI, a section 481(a) adjustment, whether positive or negative, taken into account by a taxpayer during the taxable year that is solely attributable to either the taxpayer's gross receipts, CGS, or deductions must be allocated or apportioned between DPGR and non-DPGR using the methods used by a taxpayer to allocate or apportion gross receipts, CGS, and deductions between DPGR and non-DPGR for the current taxable year. See §§ 1.199–1 and 1.199–4 for rules related to the allocation and apportionment of gross receipts, CGS, and deductions, respectively. For example, if a taxpayer changes its method of accounting for inventories from the last-in, first-out (LIFO) method to the first-in, first-out (FIFO) method and the taxpayer uses the small business simplified overall method to apportion CGS between DPGR and non-DPGR, the taxpayer is required to apportion the resulting section 481(a) adjustment, whether positive or negative, between DPGR and non-DPGR using the small business simplified overall method. If a section 481(a) adjustment is not solely attributable to either gross receipts, CGS, or deductions (for example, the taxpayer changes its overall method of accounting from an accrual method to the cash method) and the section 481(a) adjustment cannot be specifically identified with either gross receipts, CGS, or deductions, then the section 481(a) adjustment, whether positive or negative, must be attributed to, or among, gross receipts, CGS, or deductions using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, and then allocated or apportioned between DPGR and non-DPGR using the same methods the taxpayer uses to allocate or apportion gross receipts, CGS, or deductions between DPGR and non-DPGR for the taxable year or taxable years that the section 481(a) adjustment is taken into account. Factors taken into consideration in determining whether the method is reasonable include whether the taxpayer uses the most accurate information available; the relationship between the section 481(a) adjustment and the apportionment base chosen; the accuracy of the method chosen as compared with other possible methods; and the time, burden, and cost of using alternative methods. If a section 481(a) adjustment is spread over more than one taxable year, then a taxpayer must attribute the section 481(a) adjustment among gross receipts, CGS, or deductions, as applicable, in the same amount for each taxable year within the spread period. For example, if a taxpayer, using a reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, determines that a section 481(a) adjustment that is required to be spread over four taxable years should be attributed half to gross receipts and half to deductions, then the taxpayer must attribute the section 481(a) adjustment half to gross receipts and half to deductions in each of the four taxable years of the spread period. Further, if such taxpayer uses the simplified deduction method to apportion deductions between DPGR and non-DPGR in the first taxable year of the spread period, then the taxpayer must use the simplified deduction method to apportion half the section 481(a) adjustment for that taxable year between DPGR and non-DPGR for that taxable year. Similarly, if in the second taxable year of the spread period the taxpayer uses the section 861 method to apportion and allocate costs between DPGR and non-DPGR, then the taxpayer must use the section 861 method to allocate and apportion half the section 481(a) adjustment for that taxable year between DPGR and non-DPGR for that taxable year.

(h) *Disallowed losses or deductions.* Except as provided by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter), losses or deductions of a taxpayer that otherwise would be taken into account in computing the taxpayer's section 199 deduction are taken into account only if and to the extent the deductions are not disallowed by section 465 or 469, or any other provision of the Code. If only a portion of the taxpayer's share of the losses or deductions is allowed for a taxable year, the proportionate share of those allowable losses or deductions that are allocated to the taxpayer's qualified production activities, determined in a manner consistent with sections 465 and 469, and any other applicable provision of the Code, is taken into account in computing QPAI for purposes of the section 199 deduction for that taxable year. To the extent that any of the disallowed losses or deductions are allowed in a later year, the taxpayer takes into account a proportionate share of those losses or deductions in computing it QPAI for that later taxable year. Losses or deductions of the taxpayer that are disallowed for taxable years beginning on or before December 31, 2004, are not taken into account in a later year for purposes of computing the taxpayer's QPAI and the wage limitation of section 199(d)(1)(A)(iii) under §1.199–9 for that taxable year, regardless of whether the losses or deductions are allowed for other purposes. For taxpayers that are partners in partnerships, see §§1.199–5(b)(2) and 1.199–9(b)(2). For taxpayers that are shareholders in S corporations, see §§1.199–5(c)(2) and 1.199(c)(2).

(i) *Effective dates*—(1) *In general.* Section 199 applies to taxable years beginning after December 31, 2004. Sections 1.199–1 through 1.199–8 are applicable for taxable years beginning on or after June 1, 2006. For a taxable year beginning on or before May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109–222, 120 Stat. 345), a taxpayer may apply §§1.199–1 through 1.199–9 provided that the taxpayer applies all provisions in §§1.199–1 through 1.199–9 to the taxable year. For a taxable year beginning after May 17, 2006, and before June 1, 2006, a taxpayer may apply §§1.199–1 through 1.199–8 provided that the taxpayer applies all provisions in §§1.199–1 through 1.199–8 to the taxable year. For a taxpayer who chooses not to rely on these final regulations for a taxable year beginning before June 1, 2006, the guidance under section 199 that applies to such taxable year is contained in Notice 2005–14 (2005–1 C.B. 498) (see §601.601(d)(2) of this chapter). In addition, a taxpayer also may rely on the provisions of REG–105847–05 (2005–47 I.R.B. 987) (see §601.601(d)(2) of this chapter) for a taxable year beginning before June 1, 2006. If Notice 2005–14 and REG-105847–05 include different rules for the same particular issue, then a taxpayer may rely on either the rule set forth in Notice 2005–14 or the rule set forth in REG–105847–05. However, if REG–105847–05 includes a rule that was not included in Notice 2005–14, then a taxpayer is not permitted to rely on the absence of a rule in Notice 2005–14 to apply a rule contrary to REG–105847–05. For taxable years beginning after May 17, 2006, and before June 1, 2006, a taxpayer may not apply Notice 2005–14, REG–105847–05, or any other guidance under section 199 in a manner inconsistent with amendments made to section 199 by section 514 of the Tax Increase Prevention and Reconciliation Act of 2005.

(2) *Pass-thru entities.* In determining the deduction under section 199, items arising from a taxable year of a partnership, S corporation, estate, or trust beginning before January 1, 2005, shall not be taken into account for purposes of section 199(d)(1).

(3) *Non-consolidated EAG members.* A member of an EAG that is not a member of a consolidated group may apply paragraph (i)(1) of this section without regard to how other members of the EAG apply paragraph (i)(1) of this section.

(4) *Computer software.* Section 1.199–3(i)(5)(ii)(B) and (i)(6)(ii) through (v) are applicable for taxable years beginning on or after March 20, 2007. A taxpayer may apply §1.199–3(i)(5)(ii)(B) and (i)(6)(ii) through (v) to taxable years beginning after December 31, 2004, and before March 20, 2007.

(5) *Tax Increase Prevention and Reconciliation Act of 2005.* Sections 1.199–2(e)(2), 1.199–3(i)(7) and (8), and 1.199–5 are applicable for taxable years beginning on or after October 19, 2006. A taxpayer may apply §§1.199–2(e)(2), 1.199–3(i)(7) and (8), and 1.199–5 to taxable years beginning after May 17, 2006, and before October 19, 2006, regardless of whether the taxpayer otherwise relied upon Notice 2005–14 (2005–1 CB 498) (see §601.601(d)(2)(ii)(*b*) of this chapter), the provisions of REG–105847–05 (2005–2 CB 987), or §§1.199–1 through 1.199–8.

(6) *Losses used to reduce taxable income of expanded affiliated group.* Section 1.199–7(b)(4) is applicable for taxable years beginning on or after February 15, 2008. For taxable years beginning on or after October 19, 2006, and before February 15, 2008, see §1.199–7T(b)(4) (see 26 CFR part 1 revised as of April 1, 2007).

(7) *Agricultural and horticultural cooperatives.* Section 1.199–6(c) is applicable for taxable years beginning on or after March 20, 2007. A taxpayer may

apply §1.199–(6)(c) to taxable years beginning after December 31, 2004, and before March 20, 2007.

(8) *Qualified film produced by the taxpayer.* Section 1.199–3(k) is applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §1.199–3(k) to taxable years beginning after December 31, 2004, and before March 7, 2008. However, for taxable years beginning before June 1, 2006, a taxpayer may rely on §1.199–3(k) only if the taxpayer does not apply Notice 2005–14 (2005–1 CB 498) (see §601.601(d)(2)(ii)(*b*) of this chapter) or REG–105847–05 (2005–2 CB 987) (see §601.601(d)(2)(ii)(*b*) of this chapter) to the taxable year.

(9) *Expanded affiliated groups.* Section 1.199–7(e), *Example 10,* (f)(1), and (g)(3) are applicable to taxable years beginning on or after March 7, 2008. A taxpayer may apply §1.199–7(e), *Example 10,* to taxable years beginning after December 31, 2004, and before March 7, 2008.

[T.D. 9263, 71 FR 31283, June 1, 2006, as amended by T.D. 9293, 71 FR 61680, Oct. 19, 2006; T.D. 9263,72 FR 6, Jan. 3, 2007; T.D. 9317, 72 FR 12973, Mar. 20, 2007; T.D. 9381, 73 FR 8814, Feb. 15, 2008; T.D. 9384, 73 FR 12272, Mar. 7, 2008; T.D. 9381, 73 FR 16519, Mar. 28, 2008]

§1.199–9 Application of section 199 to pass-thru entities for taxable years beginning on or before May 17, 2006, the enactment date of the Tax Increase Prevention and Reconciliation Act of 2005.

(a) *In general.* The provisions of this section apply solely for purposes of section 199 of the Internal Revenue Code (Code).

(b) *Partnerships*—(1) *In general*—(i) *Determination at partner level.* The deduction with respect to the qualified production activities of the partnership allowable under §1.199–1(a) (section 199 deduction) is determined at the partner level. As a result, each partner must compute its deduction separately. The section 199 deduction has no effect on the adjusted basis of the partner's interest in the partnership. Except as provided by publication pursuant to paragraph (b)(1)(ii) of this section, for purposes of this section, each partner is allocated, in accordance with sections 702 and 704, its share of partnership items (including items of income, gain, loss, and deduction), cost of goods sold (CGS) allocated to such items of income, and gross receipts that are included in such items of income, even if the partner's share of CGS and other deductions and losses exceeds domestic production gross receipts (DPGR) (as defined in §1.199–3(a)) and regardless of the amount of the partner's share of W-2 wages (as defined in §1.199–2(e)) of the partnership for the taxable year. A partnership may specially allocate items of income, gain, loss, or deduction to its partners, subject to the rules of section 704(b) and the supporting regulations. Guaranteed payments under section 707(c) are not considered allocations of partnership income for purposes of this section. Guaranteed payments under section 707(c) are deductions by the partnership that must be taken into account under the rules of §1.199–4. See §1.199–3(p) and paragraph (b)(6) *Example 5* of this section. Except as provided in paragraph (b)(1)(ii) of this section, to determine its section 199 deduction for the taxable year, a partner aggregates its distributive share of such items, to the extent they are not otherwise disallowed by the Code, with those items it incurs outside the partnership (whether directly or indirectly) for purposes of allocating and apportioning deductions to DPGR and computing its qualified production activities income (QPAI) (as defined in §1.199–1(c)).

(ii) *Determination at entity level.* The Secretary may, by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), permit a partnership to calculate a partner's share of QPAI at the entity level, instead of allocating, in accordance with sections 702 and 704, the partner's share of partnership items (including items of income, gain, loss, and deduction). If a partnership does calculate QPAI at the entity level—

(A) The partner is allocated its share of QPAI and W-2 wages (as defined in §1.199–2(e)), which (subject to the limitations of paragraph (b)(2) of this section and section 199(d)(1)(A)(iii), respectively) are combined with the partner's QPAI and W-2 wages from other sources;

(B) For purposes of computing the partner's QPAI under §§1.199–1 through